

IT 03-6

Tax Type: Income Tax

Issue: Reasonable Cause on Application of Penalties

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS

v.

ABC & COMPANY LLP,
Taxpayer

No. 02-IT-0000
FEIN: 00-0000000
Tax Year Ended March 31, 2000

Ted Sherrod
Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorneys General Rick Walton and Jessica Arong on behalf of the Illinois Department of Revenue; Larry D. Blust of Barnes & Thornburg, on behalf of ABC & Company LLP.

Synopsis:

This matter involves a protest by ABC & Company LLP (“taxpayer”) of the Department’s denial of the taxpayer’s claim for refund of a late payment penalty assessed regarding the taxpayer’s estimate of taxes for the fiscal year ended March 31, 2000. The issues presented are: i) whether the penalty was properly computed; and ii) whether the penalty should be abated for reasonable cause, that is, because the taxpayer exercised ordinary business care and prudence when calculating an estimate of taxes. A hearing on this matter was held on February 11, 2003. At the hearing the parties offered

documentary evidence and the testimony of three witnesses. The parties have also submitted post-hearing memoranda of law. After considering the evidence offered at the hearing, and the arguments contained in the parties' memoranda, I recommend that the late payment penalty be abated to the extent imposed based on an amount exceeding the liability shown on the taxpayer's IL-1023-C filed January 16, 2001. Accordingly, the taxpayer should be allowed a refund of the late payment penalty to the extent of the penalty abatement and, as so revised, the Department's claim denial should be made final.

Findings of Fact:

1. The Department's *prima facie* case against the taxpayer, inclusive of all jurisdictional elements, was established by the admission into evidence of the LTR-353 Notice of Claim Status, dated April 8, 2002, denying the taxpayer's claim for refund for the tax year ending March 31, 2000. Dept. Ex. 1.¹
2. The taxpayer is a registered limited liability partnership headquartered in Anywhere, Indiana, and is engaged in providing accounting (audit, tax and consulting) services in 40 states including Illinois. The taxpayer, a major regional accounting firm, is the ninth largest accounting firm in the United States, and employs 1,400 professional level employees. The taxpayer maintains an Illinois office located at Anywhere, Illinois and has resident partners in this state. The taxpayer's practice includes a state and local tax department, which is engaged in providing comprehensive tax services to the taxpayer's clients. Tr. pp. 7, 9, 13, 36, 37, 38, 77, 78, 79, 80, 86, 87, 91.
3. The taxpayer was required to file a Federal tax form 1065 partnership return, a form IL-1065 and a form IL-1023-C "composite" return in Illinois for the tax year ending

March 31, 2000. The taxpayer's IL-1065 and IL-1023-C returns were originally due on July 15, 2000. The taxpayer was allowed an automatic extension to file both of these returns which extended the due date for these returns to January 16, 2001.² On or about July 13, 2000, the taxpayer filed a form IL-505-B "Automatic Extension Payment Form" reporting an estimate of additional unpaid tax due for fiscal year ended March 31, 2000 of \$65,000, and included with this form a check in this amount. Tr. pp. 14, 16, 17, 18, 91, 107, 114, 120; Dept. Ex. 2, 5, 6; Taxpayer Ex. 3.

4. The taxpayer filed both an IL-1065 and an IL-1023-C return on January 16, 2001, the extended due date for each of these returns. The taxpayer's IL-1065 showed a tax liability of zero, and tax payments "paid with Form IL-505-B" reportable on line 10 of Part II of the IL-1065 of \$65,000 for the fiscal year ended March 31, 2000. The taxpayer's IL-1023-C showed a tax liability of \$277,570, and \$151,501 in estimated taxes paid on form IL-1023-CES, but did not apply the \$65,000 paid with the taxpayer's form IL-505-B as a credit or payment toward the taxpayer's IL-1023-C liability. Tr. pp. 18, 120, 130, 131, 160; Dept. Ex. 2; Taxpayer Ex. 5.
5. The taxpayer's IL-1065 showed no liability due for fiscal year ended March 31, 2000. As a consequence, the taxpayer requested a refund of the \$65,000 credited toward the taxpayer's IL-1065 liability on its IL-1065 return filed January 16, 2001. The Department refunded this amount to the taxpayer with interest of \$2,420.19 on June 15, 2001. Tr. pp. 27, 28, 29, 55, 56, 140, 141, 160; Dept. Ex. 5; Taxpayer Ex. 8, 10.

¹ Unless otherwise noted, findings of fact apply to the tax period in controversy.

² While the statutory due date for the taxpayer's return was January 15, 2001, the due date was extended to January 16, 2001 because January 15, 2001 was a legal holiday. See 86 Ill. Admin. Code, ch. I, sec. 1910.25.

6. Subsequent to the filing of its IL-1065 and IL-1023-C, the taxpayer determined that it had improperly calculated its federal income tax liability reported on its Internal Revenue Service (“IRS”) form 1065 for the fiscal year ended March 31, 2000. Accordingly, John Doe, the taxpayer’s tax manager amended its federal tax return by filing an amended IRS form 1065 on or about May 22, 2001. The filing of an amended Federal return legally obligated the taxpayer to file amended returns in other jurisdictions, including Illinois. Mr. Doe attempted to report this federal change to Illinois by improperly filing an amended IL-1023-C and amended IL-1065 on May 22, 2001, and by subsequently properly reporting this federal change by filing form IL-843 on July 16, 2001. Accordingly, the amended IL-1023-C, the amended IL-1065 and the form IL-843 were filed within 120 days of the amended federal return. The taxpayer paid additional tax due in the amount of \$83,896 with its improperly filed amended IL-1023-C on May 22, 2001. Tr. pp. 18, 19, 54, 132, 133, 135, 136, 137, 138, 139, 140, 142, 143, 144; Taxpayer Ex. 4, 6, 7.
7. After reviewing the taxpayer’s IL-843 reporting federal changes to the taxpayer’s income reported on its IL-1023-C for FYE 3/31/00, the Department determined that the taxpayer’s taxes due on its IL-1023-C by July 15, 2000 (the original return due date), exceeded taxes paid by the taxpayer by this date. Estimated payments reported on the taxpayer’s IL-1023-C filed January 16, 2001 were \$151,501. However, the Department determined that, because of federal changes, a substantial increase in the taxpayer’s Illinois sales, an increase in the number of the taxpayer’s non-resident partners and Illinois’ reweighting of the statutory sales factor of its apportionment

formula used to assign income to the state³, the taxpayer's IL-1023-C liability due on July 15, 2000 was \$361,466. Accordingly, on August 24, 2001, the Department notified the taxpayer that it had assessed a 20 percent late payment penalty due to the taxpayer's failure to make timely tax payments, in the amount of \$41,993 plus statutory interest of \$13,520.82. In arriving at this determination, the Department used the tax shown due on the amended return, and did not take into account the \$65,000 paid with the form IL-505-B filed on July 13, 2000. In response to this assessment, the taxpayer, on August 24, 2001, filed a request for abatement of penalty, which was denied on September 25, 2001. Thereafter, the taxpayer made a payment of \$29,294 for penalty and \$13,890 for interest on or about November 7, 2001. On February 19, 2002, the taxpayer filed an amended IL-843 claiming a refund for late payment penalties assessed based on its belief that the facts and circumstances of the late estimated payments constituted reasonable cause for abatement of the penalty under Illinois law. On April 8, 2002, the Department issued a Notice of Denial denying the taxpayer's refund claim. The taxpayer's tax matters partner, Joe Blow, subsequently filed a timely protest contesting the Department's refund claim denial. Tr. pp. 134, 135, 139, 140, 145, 146, 147, 148, 149, 150; Dept. Ex. 1; Taxpayer Ex. 2, 9, 10, 11, 12, 13.

8. Prior to January 15, 2000, Mr. Ron Doe, the taxpayer's tax manager, was responsible for preparing the taxpayer's state and local tax returns including the IL-1065 and the IL-1023-C. On January 15, 2000, Mr. Ron Doe unexpectedly resigned this position and left the taxpayer. This resignation was not anticipated, and the taxpayer was

³ See section 304(h) of the Illinois Income Tax Act, 35 ILCS 5/304(h).

unable to find an immediate replacement for Mr. Ron Doe. Mr. Ron Doe's resignation occurred only six months before returns were due in 40 states. Since the taxpayer failed to find a replacement for Mr. Ron Doe, in the spring of 2000, Mr. Smith, the taxpayer's controller, assigned the responsibility for filing state estimated payments to Mr. Jones, a tax analyst who had been with the taxpayer for less than 6 months, and had no state and local tax experience. Tr. pp. 13, 42, 43, 71, 72, 88, 89, 90, 91, 102; Taxpayer Ex. 2, 10.

9. Mr. Jones is a financial analyst with the taxpayer. He is assigned to the taxpayer's operations group and is supervised by Mr. Smith, the taxpayer's controller, and by the taxpayer's assistant controller. He joined the taxpayer on January 17, 2000. Prior to assuming tax compliance responsibilities, Mr. Jones's duties were to assist in the preparation of the annual company budget, and the general account reconciliation, the conduct of audits of internal ledger accounts, general ledger research and to perform special projects on an ad hoc basis. Tr. pp. 31, 32, 38, 39, 40, 41, 42, 43.
10. Mr. Jones has a bachelor's of science degree from Western Michigan University with a major in finance and received an M.B.A. from Indiana University in 1999. Before joining the taxpayer, Mr. Jones worked for the Credit Union located in Anywhere, Indiana for approximately eight years where he was employed as a branch manager and underwriting supervisor. Tr. pp. 32, 33, 34, 35, 36.
11. John Doe is the tax manager for internal tax funds (i.e. income taxes, payroll taxes, sales and uses taxes) for the taxpayer. He is under the supervision of Mr. Smith, the taxpayer's controller and Joe Blow, the taxpayer's tax matters partner. He was hired by the taxpayer on October 9, 2000. Mr. Doe's duties include the preparation of tax

returns for the taxpayer, including the taxpayer's IL-1023-C and the taxpayer's IL-1065 partnership return. In December, 2000, Mr. Doe prepared the taxpayer's IL-1023-C and the taxpayer's IL-1065 for the taxpayer's fiscal year ending March 31, 2000. These returns were reviewed by Joe Blow, the tax matters partner, before being signed and filed by Mr. Jim Doe. Tr. pp. 53, 54, 55, 83, 84, 110, 111, 129, 130; Taxpayer Ex. 10.

- 12.** Mr. Doe has a bachelor's degree in business administration and a Masters of Science in Taxation, and is a CPA licensed to practice in Michigan and Indiana. Mr. Doe has taken a course in state and local tax and regularly attends seminars on this subject. Before becoming an employee of the taxpayer, Mr. Doe was employed by Accounting Firms and (immediately before joining the taxpayer) as a tax senior by a corporate consulting firm. Tr. pp. 58, 59, 60, 61.
- 13.** Mr. Smith is the Controller of the taxpayer and supervisor of the taxpayer's operations department. His duties include the preparation of the taxpayer's general ledger, producing financial reports on a monthly and annual basis, oversight of the 401(k) plan's administration, responsibility for the taxpayer's budgeting process, and interim supervision of the taxpayer's tax compliance functions performed by Mr. Jones. Mr. Smith has an undergraduate degree in accounting and has been employed by the taxpayer for over eight years. Prior to joining the taxpayer, Mr. Smith was employed by Attorneys at Law, as an Accounting Manager. His duties at Attorneys at Law did not include tax compliance. Tr. pp. 70, 71, 72, 82, 83, 84, 85, 86.
- 14.** Joe Blow is the taxpayer's tax matters partner. He is a partner in the taxpayer, is not assigned full time to the operations department and does not have an office in that

department. He is responsible for signing and filing the taxpayer's returns and oversight and final review of these returns. As part of these duties, he conducted a final review of the taxpayer's returns filed for FYE 3/31/00, including the taxpayer's form IL-1023-C and IL-1065 returns. However, although it was standard practice for the tax matters partner to do so, he did not review the IL-505-B prepared by Mr. Jones. Tr. pp. 84, 85, 93, 97, 129, 130; Taxpayer Ex. 10.

15. During June and July, 2000, Mr. Jones prepared and filed an IL-505-B automatic extension payment form for the tax year ended March 31, 2000, in accordance with past practice at the taxpayer. To determine the taxpayer's estimated composite taxes for FYE 3/31/00, Mr. Jones applied the taxpayer's prior year apportionment formula to the taxpayer's current year estimated composite income. An estimated payment amount of \$65,000 was computed based on this estimate regarding the composite tax return liability for the 2000 fiscal year. Tr. pp. 43, 44, 102, 103, 104, 105, 106, 107; Dept. Ex. 3.

16. John Doe prepared the taxpayer's IL-1023-C return and its IL-1065 return for the taxpayer's fiscal year ended March 31, 2000, and these returns were filed on January 16, 2001. The IL-1065 showed a credit for the \$65,000 included with the form IL-505-B filed by Mr. Jones. The application of the \$65,000 payment made with the IL-505-B to the liability shown due on the IL-1065 occurred because Mr. Doe thought that the IL-505-B payment had been made to cover the firm's IL-1065 tax liability. Since the partnership had no entity level liability shown on its IL-1065, the return Mr. Doe prepared showed an overpayment of \$65,000. Mr. Doe requested a refund of this overpayment, and the Department refunded the \$65,000 paid with the IL-505-B

with interest on January 29, 2001. Tr. pp. 54, 55, 56, 57, 58, 62, 63, 64, 65, 66, 67, 68, 69, 141; Dept. Ex. 5; Taxpayer Ex. 8.

Conclusions of Law:

Section (b-5)(1) of the Uniform Penalty and Interest Act (“UPIA”), 35 ILCS 735/3-3(b-5)(1) provides in part as follows:

A penalty of 20% of the tax shown on the return or the tax required to be shown due on the return shall be imposed for failure to pay:
(1) the tax shown due on the return on or before the due date prescribed for payment of that tax, an amount of underpayment of estimated tax, or an amount that is reported in an amended return other than an amended return timely filed as required by subsection (b) of Section 506 of the Illinois Income Tax Act (penalty for late payment or nonpayment of admitted liability) ... [.]

The Department imposed a penalty under section (b-5)(1) of the UPIA against the taxpayer for the tax year ended March 31, 2000. Taxpayer Ex. 9. The taxpayer, a limited liability partnership, was required to file an IL-1065 partnership return and an IL-1023-C return for its fiscal year ended March 31, 2000 on or before July 15, 2000. Tr. pp.14, 114; 35 ILCS 5/505(a)(2); 86 Ill. Admin. Code, ch. I, sec. 100.5000(a)(4). While both of these returns are filed by partnerships, they are fundamentally different.

Form IL-1065, like its federal tax counterpart, IRS form 1065, reports the profit, loss and income of the partnership as a separate legal entity. See form IL-1065; IL-1065 Instructions, pages 1-7. While a partnership as such is not taxable under the general provisions of the Illinois Income Tax Act, it is subject to special provisions of this Act imposing a Personal Property Replacement Tax enacted in 1979. *Id.*; 35 ILCS 5/201(a); 35 ILCS 5/201(c); 35 ILCS 5/205(b). The partnership return is used to determine the partnership entity’s liability under this special replacement tax. *Id.*

Partners are also taxed on their distributive share of partnership income. 35 ILCS 5/205(b). Accordingly, individual partners must include partnership income in their individual income tax returns. Non-residents deriving income from Illinois who are partners in a partnership may avoid filing individual returns in this state by including their income in what is called an IL-1023-C “composite” return. 35 ILCS 5/502(f); 86 Ill. Admin. Code, ch. I, sec. 100.5100; 86 Ill. Admin. Code, ch. I, sec. 100.5130. The return includes the composite income of all non-resident partners electing to report income to Illinois as part of a single return filed on the partners’ behalf by the partnership. *Id.* However, while the composite return is filed by the partnership, it reports the income of individual partners, rather than the income derived by the partnership as a separate legal entity. See form IL-1023-C; IL-1023-C Instructions, pp. 1 – 3.⁴

The record shows that the taxpayer made timely estimated tax payments on its IL-1023-C return of \$151,501 against an assessed corrected liability of \$361,466, resulting in a tax underpayment of \$209,965. The corrected liability used in arriving at an assessment was the tax shown due on the taxpayer’s IL-843 return, (filed on July 16, 2001), reporting federal changes. Dept. Ex. 4; Taxpayer Ex. 9. Partnerships are required to report federal changes on form IL-843 “Amended Return or Notice of Change in Income.” See form IL-843; form IL-843 Instructions, pp. 2-4. This amended return was filed by the taxpayer pursuant to section 506(b) of the Illinois Income Tax Act (“IITA”),

⁴ Composite partner income is apportioned to Illinois pursuant to 35 ILCS 5/304. 86 Ill. Admin. Code, ch. I, sec. 100.5130.

35 ILCS 5/506(b) and reported federal income tax changes resulting from the taxpayer's amendment of its FYE 3/31/00 federal tax form 1065. Taxpayer's Post Hearing Brief (hereinafter cited as Taxpayer's Brief) pp. 11, 12; Department's Post-Trial Brief (hereinafter cited as Department's Brief) pp. 11, 12. The taxpayer's IL-843 was filed within 120 days of the filing of the taxpayer's federal IRS form 1065 in accordance with section 506(b) of the IITA. *Id.* In computing a penalty, the Department used the amount shown due on the taxpayer's IL-843, reporting federal changes, of \$361,466. Dept. Ex. 4; Taxpayer Ex. 9.

The Department's determination is presumed correct. 35 ILCS 5/904(a); PPG Industries v. Department of Revenue, 328 Ill. App. 3d 16 (1st Dist. 2002); A.R. Barnes and Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988). Once the presumed correctness of the assessment is established, the burden shifts to the taxpayer to prove that the determination was in error. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968); Central Furniture Mart v. Johnson, 157 Ill. App. 3rd 907 (1st Dist. 1987); Vitale v. Department of Revenue, 118 Ill. App. 3rd 210 (3rd Dist. 1983); Masini v. Department of Revenue, 60 Ill. App. 3rd 11 (1st Dist. 1978); PPG Industries, supra; A.R. Barnes and Co., supra.

The taxpayer contends that the Department has committed numerous errors in arriving at its assessment determination in this case. Taxpayer's Brief pp. 1, 2, 10, 11. The taxpayer's initial contention is that the Department erroneously based the penalty imposed in this case on the tax shown due on the taxpayer's timely filed IL-843 amended return for FYE 3/31/00 reporting federal changes in accordance with 35 ILCS 5/506(b). Taxpayer's Brief pp. 11, 12. Section 3-3(b-5)(1) of the UPIA expressly provides that an

underpayment penalty may be imposed on “an amount that is reported in an amended return other than an amended return timely filed as required by subsection (b) of Section 506 of the Illinois Income Tax Act ... [.]” The UPIA precludes the imposition of a late payment penalty on the unpaid amount shown due on an amended return filed pursuant to section 506(b) of the IITA. Moreover, the Department, in its Post-Trial Brief, concedes that the imposition of the penalty based on a liability of \$361,466, the amount shown on the taxpayer’s amended return (Dept. Ex. 4) reporting federal changes, was in error. Department’s Brief pp. 11, 12. Accordingly, the amount used in computing the taxpayer’s 20% late payment penalty cannot exceed \$277,570, which is the amount shown due on the taxpayer’s IL-1023- C return filed on January 16, 2001. Dept. Ex. 2.

The taxpayer also claims that the penalty for late payment of its 2000 IL-1023-C liability was not properly calculated. Taxpayer’s Brief pp. 12, 13, 14. Again, section 3-3(b-5)(1) of the UPIA states that the late payment penalty is 20 percent of the tax properly due on the return. However, under section 3-3(c) of the UPIA, 35 ILCS 735/3-3(c), the tax is to be reduced by any part of the tax that is paid on time and any credit that is properly allowable on the date the return was required to be filed. The IL-1023-C return filed by the taxpayer showed an IL-1023-C liability of \$277,570 and timely estimated taxes paid of \$151,501. Dept. Ex. 2. Accordingly, the Department seeks to apply the \$151,501 that was timely paid as a credit toward the IL-1023-C liability and compute the penalty on the remaining unpaid amount of \$126,069. Taxpayer’s Brief pp. 11, 12, 13, 14.

On July 13, 2000, the taxpayer filed a return extension request on form IL-505-B and paid estimated additional tax due toward its FYE 3/31/00 liability of \$65,000. Dept.

Ex. 6; Taxpayer Ex. 3. This filing was made in accordance with 86 Ill. Admin. Code, ch. I, sec. 100.5020(b), which provides as follows:

The Department will grant an automatic extension of 6 months (7 months for corporations) to file any Illinois income tax return except Form IL-941. No application form need be filed by a taxpayer to obtain this extension. If a balance of tentative tax is due, the taxpayer should transmit the payment with the appropriate form (Form IL-505-I and Form IL-505-B) by the original filing due date in order to avoid the penalty for underpayment of tax (IITA Section 1005) and statutory interest (IITA Section 1003).

The taxpayer contends that the amount included with its IL-505-B extension request should have been credited to the IL-1023-C liability shown on the taxpayer's return. Taxpayer's Brief pp. 12, 13, 14. Since the estimated payment included with this form was made on July 13, 2001, the taxpayer argues that it had paid \$216,501 toward the IL-1023-C liability by July 15, 2001, the due date of the IL-1023-C, not \$151,501, as the Department contends. *Id.* Consequently, it argues, the penalty should have been computed on an unpaid liability of \$61,069, and not on the alleged unpaid liability of \$126,069, as the Department maintains. *Id.*

The Department contends that the \$65,000 included with the taxpayer's IL-505-B was refunded to the taxpayer prior to the computation of the late payment penalty, and therefore could not be taken into account in computing this penalty. Department's Brief pp. 14, 15, 16. Contrary to this claim, the taxpayer maintains that the refund was improper, and therefore the amount paid with the IL-505-B must be taken into account in computing an underpayment penalty. Taxpayer's Brief pp. 13, 14.

Irrespective of the refund paid to the taxpayer, the penalty could not have been assessed on \$126,069 if the \$65,000 included with the IL-505-B was properly attributable

to the estimate of taxes due on the taxpayer's IL-1023-C as the taxpayer contends. This is clear from the plain language of section (b-5)(1) of the UPIA which states that the penalty is due for failure to pay "the tax shown due on a return on or before the due date prescribed for payment of that tax ... [.]” (emphasis added) Pursuant to this provision, the underpayment penalty is the difference between the amount properly credited to the taxpayer's IL-1023-C account on the due date for the IL-1023-C, July 15, 2000, and the amount shown to be due on this return. The taxpayer's IL-505-B, which included a check for \$65,000, was filed on July 13, 2000, prior to the due date for the IL-1023-C. Consequently, if the \$65,000 is properly credited to the IL-1023-C, the amount paid on the IL-1023-C liability on the due date of this return would have been \$216,501, not \$126,069 as the Department contends.

However, the record contains no documentary evidence that the \$65,000 payment included with the IL-505-B was properly attributable to the IL-1023-C rather than to the taxpayer's IL-1065 to which it was credited. It was incumbent upon the taxpayer to make this showing because under 35 ILCS 5/904(a), the Department's finding that the \$65,000 was properly attributable to the IL-1065, implicit in its denial of the taxpayer's refund claim, is presumed correct.⁵ In order to rebut this presumption, the taxpayer must prove that the Department's determination was in error by producing more than mere testimony. A.R. Barnes and Co. Such documentary evidence might have included a letter to the Department directing it to apply the IL-505-B payment to the IL-1023-C, or

⁵ The Department's penalty determination giving rise to the taxpayer's refund claim resulted from its review of the taxpayer's IL-843 "Amended Return and Notice of Change in Income", and thus is a determination based upon an examination of the taxpayer's "return" to which 35 ILCS 5/904(a) applies.

internal books and records showing that the payment was intended to be applied in this manner.

The record does not support the taxpayer's claim that the \$65,000 must be attributed to the IL-1023-C liability. Indeed, there is testimony in the record that the IL-505-B the taxpayer filed intended to assign the \$65,000 payment included with the IL-505-B to the IL-1065. Tr, pp. 57, 58, 62, 63. Moreover, the documentary record also indicates that the taxpayer actually reported the \$65,000 as an amount to be credited to the anticipated tax due on the taxpayer's IL-1065. This payment was reported on Part II, line 10 of the IL-1065 which is captioned "(T)ax paid with Form IL-505-B. " Dept. Ex. 5.

When Mr. Doe filed the IL-1065 on January 16, 2001, he erroneously believed that the IL-505-B payment had been credited to the IL-1065 at the time the IL-505-B was filed. Tr. pp. 56, 57, 58, 62, 63, 64, 65, 66. The fact that Mr. Doe was mistaken in his belief that the \$65,000 was attributable to the IL-1065 when he filed this return does not change the fact that the credit for the IL-505-B payment was actually taken on this return rather than on the IL-1023-C. Once taken in this manner, this amount could not be reassigned to the IL-1023-C by the taxpayer. As pointed out by the taxpayer in its brief, instructions to the 1999 IL-1023-C clearly state that "Form IL-1023 cannot be amended to transfer tax payments or overpayments from (or to) any other type of return ... [.]” 1999 IL-1023-C Instructions, p. 2; Taxpayer's Brief p. 13. These instructions have the force and effect of Department regulations pursuant to 35 ILCS 5/1401 and 35 ILCS 5/1501(a)(19). There is no "mistaken belief" or other exception to this prohibition that allows a taxpayer to move an erroneously reported IL-1065 payment from the IL-1065 to

the IL-1023-C. Thus, testimony that the \$65,000 paid with the IL-505-B was intended to be attributed to the IL-1023-C, rather than to the IL-1065 where this tentative tax payment was reported, provides no legal basis for the relief the taxpayer seeks.

Admittedly, the Department had the discretion to apply the overpayment on the taxpayer's IL-1065 to cover the underpayment on the taxpayer's IL-1023-C. This discretion is granted to the Department under section 909(a) of the Illinois Income Tax Act, 35 ILCS 5/909 which provides in part as follows:

- (a) In general. In the case of any overpayment, the Department may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of the tax imposed by this Act, regardless of whether other collection remedies are closed to the Department on the part of the person who made the overpayment and shall refund any balance to such person.

Similar provisions are also found in the Civil Administrative Code, 20 ILCS 2505/2505-275 (formerly 20 ILCS 2505/39e), and the Department's regulation concerning credits and refunds, 86 Ill. Admin. Code, ch. I, sec. 100.9400(a). While the Department did not suffer any financial harm as a result of the taxpayer's underpayment of estimated tax on its IL-1023-C because the taxpayer repaid the \$65,000 it was refunded with interest (Taxpayer's Brief p. 14), the Department clearly acted within its discretion when it refused to apply the overpayment on the IL-1065 in this manner. Neither the statutes nor the regulation noted above mandate the Department to do anything; these laws simply state that the Department may credit overpayments to other liabilities. Moreover, the Department did not abuse its discretion in refusing to do so, since 35 ILCS 909(a) is primarily designed to accord the benefit of tax overpayments to cover other liabilities of the person who made them. See 86 Ill. Admin. Code, ch. I, sec. 9400(a) ("The Department may credit the amount of any overpayment including interest thereon against

any liability for tax imposed under the IITA or any other Act administered by the Department on the person who made the overpayment... [.]” emphasis added). As noted above, the IL-1023-C reports the composite liabilities of individual partners rather than liabilities of the partnership itself. Hence, using the \$65,000 overpayment reported by the partnership on its IL-1065 return to cover the separate liabilities of the individual partners would apply the overpayment by the partnership to a non-partnership liability, and thus produce a result section 909(a) is not primarily designed to achieve.

In sum, since the Department cannot be required to give the taxpayer credit for the overpayment on its IL-1065 in computing the taxpayer’s timely paid IL-1023-C liability, it acted within its statutory discretion when it refused to make this adjustment. Consequently, the Department properly exercised its statutory authority when it determined that the \$65,000 credited by the taxpayer on its IL-1065 could not be treated as a payment toward its IL-1023-C liability made prior to July 15, 2000, the due date of the IL-1023-C.

The taxpayer also argues that the circumstances resulting in the taxpayer’s underpayment of estimated taxes establish grounds for abatement of the penalty imposed in this case under section 3-8 of the UPIA, 35 ILCS 735/3-8. Section 3-8 of the UPIA provides as follows:

No penalties if reasonable cause exists. The penalties imposed under the provisions of Sections 3-3, 3-4, 3-5, and 3-7.5 of this Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with the rules and regulations promulgated by the Department. A taxpayer may protest the imposition of a penalty under Section 3-3, 3-4, 3-5, or 3-7.5 on the basis of reasonable cause without protesting the underlying tax liability.

Pursuant to authority granted by the legislature, the Department has promulgated rules interpreting reasonable cause at 86 Ill. Admin. Code, ch. I, sec. 700.400. These rules provide in part as follows:

- a) The penalties imposed under the provisions of Sections 3-3, 3-4, 3-5, and 3-7.5 of the Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with this Section. (Section 3-8 of the Act)
- b) The determination of whether a taxpayer acted with reasonable cause shall be made on a case by case basis taking into account all pertinent facts and circumstances. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion.
- c) A taxpayer will be considered to have made a good faith effort to determine and file and pay his proper tax liability if he exercised ordinary business care and prudence in doing so. A determination of whether the taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. Accordingly, reliance on the advice of a professional does not necessarily establish that a taxpayer exercised ordinary business care and prudence, nor does reliance on incorrect facts such as an erroneous information return.
- d) The Department will also consider a taxpayer's filing history in determining whether the taxpayer acted in good faith in determining and paying his tax liability. Isolated computational or transcriptional errors will not generally indicate a lack of good faith in the preparation of the taxpayer's return.

The most important factor to be considered in deciding whether to abate a penalty is the extent to which the taxpayer made a good faith effort to comply. 86 Ill. Admin. Code, ch. I, sec. 700.400(b). A taxpayer will be considered to have made a good faith effort to comply if it exercised ordinary care and prudence in doing so. 86 Ill. Admin. Code, ch. I, sec. 700.400(c). The record shows that on January 15, 2000, Ron Doe, the taxpayer's tax manager responsible for preparing the taxpayer's state and local tax

returns, suddenly resigned. Tr. p. 42. After a futile effort to find a new tax manager, the taxpayer's controller temporarily assigned responsibility for estimating tax due to Mr. Jones, a financial analyst who had been with the company less than six months and had no state and local tax experience. Tr. pp. 42, 43, 71, 72, 102; Taxpayer Ex. 2, 10. The record shows that errors and omissions by Mr. Jones resulted in a failure to properly estimate tax due for FYE 3/31/00. Department's Brief pp. 16, 17, 18, 19; Taxpayer's Brief pp. 16, 17, 18.

On its face, the assignment of responsibility for estimated tax payments and extensions to a financial analyst who had no tax experience and had been with the company only a short time would not appear to be a careful and prudent means to insure proper tax compliance. The taxpayer contends this temporary measure was necessitated by its inability to quickly locate a suitable replacement for Mr. Ron Doe. Tr. pp. 13, 14, 88, 89, 90, 91; Taxpayer's Brief pp. 16, 17. It also argues that Mr. Jones was the most qualified person available to fill this position. Tr. p. 86. I do not find either of these assertions to be credible. The record shows that the taxpayer has a professional staff of 1400, and a highly sophisticated state and local tax practice. Tr. pp. 7, 79, 80, 81, 82. Given this wealth of talent, it is inconceivable that the taxpayer could not have located a more qualified individual than Mr. Jones to prepare its IL-505-B. Accordingly, I do not find the taxpayer's decision to employ Mr. Jones in this capacity evidence that the taxpayer exercised ordinary care and prudence in attempting to comply with the Illinois law. The decision to move Mr. Jones into this position rather than someone from the firm's state and local tax department reflects the understandable lesser importance given internal affairs than the more lucrative practice areas of the firm. However, the

taxpayer's decision to appropriate its most talented and qualified individuals to income producing practice functions rather than to internal compliance cannot be viewed as reasonable cause to excuse the taxpayer's compliance omissions.

The record also indicates that Mr. Jones was not subject to any supervision by a knowledgeable tax expert within the partnership. Tr. p. 44. Mr. Smith, who exclusively supervised Mr. Jones, had a limited background in tax and was not a tax expert. Tr. pp. 72, 73, 74. The evidence shows that Mr. Smith, the taxpayer's controller, delegated all responsibilities for preparing tax estimates to Mr. Jones, a tax novice, and trusted that he would be capable of handling them competently. Tr. p. 43; Taxpayer Brief pp. 16, 17.

In fact, the record shows that normal internal checks and controls implemented to avoid compliance errors were not followed in this case. Mr. Smith admitted that, while the firm's tax matters partner ordinarily reviews the IL-505-B before it is filed, such a review was never undertaken in this case. Tr. p. 97. The courts have repeatedly held that a taxpayer's failure to implement and follow internal checks and controls over an employee responsible for tax obligations demonstrates a lack of ordinary business care and prudence, and as such, negates a claim that late filings, deposits and payments are due to reasonable cause. Thom v. U.S., 47 AFTR 2d 81-430 (D.Or.1980); Obstetrical Gynecological Group v. U.S., 44 AFTR 2d 79-5438 (D.D.C. 1979); Universal Concrete Products Corp. v. United States, 71A AFTR 2d 93-3852 (E.D.Pa. 1990).⁶ It is clear from the evidence submitted that, despite the obvious need for special care given the unusual

⁶ Federal cases cited here construing "reasonable cause" provisions of the Internal Revenue Code are relevant in determining what constitutes "reasonable cause" under 35 ILCS 735/3-8. 35 ILCS 5/102 provides that terms used in the Illinois Income Tax Act have the same meaning as when used in a comparable context in the Internal Revenue Code. The use of the term "reasonable cause" in the Internal Revenue Code (at 26 USCA 6651) is comparable to the use of this term in 35 ILCS 735/3-8 since both of these statutes address what constitutes "reasonable cause" for failure to timely pay income taxes.

circumstances created by Mr. Ron Doe's sudden departure, Mr. Jones was not properly supervised and normal procedures to better insure tax compliance were not adhered to. This is clear evidence of the absence of the exercise of ordinary business care and prudence. This evidence clearly supports the Department's determination that the taxpayer failed to demonstrate "reasonable cause" under 86 Ill. Admin. Code, ch. I, sec.700.400.

Despite the above, the taxpayer cites 86 Ill. Admin. Code, sec. 700.400(e)(3) as support for its position that there was reasonable cause for the taxpayer's compliance omissions. Taxpayer's Brief pp. 15, 16. Subdivision (e)(3) provides as follows:

- 3) An unavoidable absence of a taxpayer (or tax preparer) due to circumstances unforeseeable by a reasonable person may also constitute reasonable cause for purposes of abatement of the penalty. An unavoidable absence does not include a planned absence such as a vacation. In the case of a corporation, estate, trust, etc., the absence must have been of an individual having sole authority to file the return (not the individual preparing the return) or make the deposit/payment.

However, a review of the record indicates that Jim Doe, the tax matters partner, had the ultimate authority to sign and file returns on behalf of the taxpayer. Tr. p. 93. Mr. Jim Doe continued to exercise this authority after Mr. Ron Doe resigned. Tr. pp. 84, 85. Since Mr. Jim Doe had authority to sign and file the taxpayer's returns, the facts in this case do not support a finding that "an individual having sole authority to file the return" was unavailable.

The taxpayer also cites subdivision (e)(7) of 86 Ill. Admin. Code, ch. I, sec. 700.400 as support for its position that the penalty imposed in this case should be excused

for “reasonable cause.” Taxpayer’s Brief p. 15. Subdivision (e)(7) of this regulation provides as follows:

- 7) Reasonable cause will exist for purposes of abatement of the penalty if a taxpayer makes an honest mistake, such as inadvertently mailing a Department of Revenue check to a local government, another state’s Department of Revenue, or to the Internal Revenue Service.

The record shows that, even if the \$65,000 paid with the IL-505-B had been applied to the IL-1023-C liability, a substantial underpayment of tax due would have arisen. The amount of tax properly due on the due date of the return was \$277,570. Including the \$65,000, the estimated tax paid by the return due date would have been \$216,501.

The taxpayer’s underpayment resulted primarily from Mr. Jones’s failure to properly compute the correct Illinois apportionment ratio for the taxpayer. Department’s Brief p. 17; Taxpayer’s Brief p. 18. The record shows that the apportionment ratio used in determining the taxpayer’s IL-1023-C liability was taken directly from the taxpayer’s 1999 return. Mr. Jones admitted during testimony that he applied the prior year’s apportionment ratio in arriving at an estimate of the taxpayer’s income for FYE 3/31/00. Tr. p. 104. Mr. Jones and his supervisor were, or should have been aware that, given the unlikely prospect of no change in the partnership’s operations since 1999, they did not have all of the facts necessary to accurately estimate the taxpayer’s apportionment ratio when the IL-505-B was filed. Given the likely inaccuracy of the prior year’s apportionment ratio, a person acting with ordinary care and prudence would seek to arrive at a more accurate approximation of the apportionment percentage for the current year based on the best information available. However, the record in this case is devoid of any evidence that any more accurate determination was ever attempted.

The absence of any effort to determine a 2000 apportionment ratio is acknowledged in the taxpayer's brief. Taxpayer's Brief pp. 17, 18; Taxpayer's Post-Hearing Reply Brief pp. 10, 14. Clearly much of the information necessary to precisely determine this ratio was not ready when the IL-505-B was filed. Nevertheless, such an effort might have at least discovered that the weight given Illinois sales in apportioning income to this state had been increased. This change had been in effect for 2 years when the IL-505-B was filed.⁷ Had such an effort been undertaken but nevertheless resulted in a faulty apportionment ratio due to the complete absence of necessary information, a basis for a finding of an "honest mistake" might exist. However, the failure to do so, in favor of complete reliance on the prior year's suspect apportionment ratio demonstrates a lack of care that does not support such a finding. If reasonable steps are not taken to ascertain the correct amount of tax due, there is no reasonable cause for the abatement of penalties. See 86 Ill. Admin. Code, ch. I, sec. 700.400(b) ("The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion").

The taxpayer, at page 17 of its Post-Hearing Brief, also points out the firm's unblemished compliance record as a factor to be considered in determining reasonable cause. See 86 Ill. Admin. Code, ch. I, sec. 700.400(d). While a good compliance record may be taken into account in determining reasonable cause under the Department's regulations, it is only one of several factors to be considered and, in and of itself, is not

⁷ The weighting of the sales factor of the Illinois apportionment formula for 1999 and 2000 was changed by the enactment of 35 ILCS 5/304(h), effective July 9, 1998. See P.A. 90-613, Laws 1998 effective July 9, 1998.

decisive. After a review of the record, I find that the taxpayer's good compliance record is insufficient to establish reasonable cause given evidence noted above that negates a finding of reasonable cause in this case.

WHEREFORE, for the reasons stated above, I recommend that the Department's denial of the taxpayer's claim for refund be revised. The taxpayer's refund claim should be allowed to the extent the late payment penalty was imposed based on the amount shown due on the taxpayer's IL-843 filed July 16, 2001 exceeding the amount shown due on the taxpayer's IL-1023-C filed January 16, 2001. As revised, the denial of the taxpayer's refund claim should be made final.

Ted Sherrod
Administrative Law Judge

Date: June 4, 2003